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SUBJECT: ECONOMIC LEADERS MUST FOCUS ON DEFENSE; IMF
LEAVING SRI LANKA

REF: COLOMBO 2063

11. (SBU) Summary: Corruption within the Government of Sri Lanka (GSL), shifting of budgetary allocations for defense expenditures, Sri Lanka,s true potential for economic growth, and the planned closure of the International Monetary Fund,s (IMF,s) Resident Office in Sri Lanka, were topics on December 15 when the Ambassador met with IMF Resident Representative Luis Valdivieso. While Valdivieso described the GSL as being focused on the conflict with little time to focus on economic development, he assessed the currently-embattled Treasury Secretary as a visionary who could move Sri Lanka toward greater economic prosperity, if not required to use his skills and creativity to finance a conflict. End Summary.

MILITARY FINANCING VIA LINE ITEM SHIFTS

12. (SBU) Valdivieso in a December 15 meeting with Ambassador Blake said that that GSL,s defense allocation for 2007 is expected to be about 4.3 percent of GDP, an increase of about 0.7 percent over 2006. (See reftel for more coverage of the 2007 budget.) Valdivieso said that large portions of funding targeted for other purposes were used for 2006 military expenditures. He cited as an example that as much as 75 percent of the 2006 budget allocation to provide housing for citizens displaced by the conflict was shifted to cover military and related security obligations. He added that most of the defense budget goes to recurrent military expenditures, such as salaries, special allowances and pensions, with virtually all military hardware procurements for 2007 to be obtained off-budget via government-to-government programs, resulting in loans for such acquisitions being deferred, to appear only in future budgets.

SRI LANKA,S POTENTIAL FOR ECONOMIC GROWTH

13. (SBU) Although stating that the Sri Lankan economy has shown "great resilience" over the past few years, Valdivieso qualified the term "resilience," showing that he was using it in a different manner than is so commonly used by Sri Lankan optimists. Where the optimists point to continued 6-8

percent growth throughout many years of conflict, extrapolating that Sri Lanka is an unstoppable engine of moderate growth, Valdivieso identified the GSL's skill in using donor funds following the tragic tsunami of December 2004 to rescue Sri Lanka from what was about to become an "economic disaster." The post-tsunami donor aid enabled Jayasundera to use the debt relief, debt deferral and tsunami assistance provided by many countries to enhance the GSL budget. Valdivieso projected that this type of donor assistance, and Treasury's ability to use this tool to mask the GSL's economic situation, could continue through 2007, but would then diminish significantly as deferred loans become due and as other aid decreases.

14. (SBU) Valdivieso, who has experience in several countries that have seen conflict, including East Timor, Tajikistan and El Salvador, said that countries with conflict often see as much as a 20 percent spike in economic growth following conflict. However, war-affected countries frequently revert to conflict after a period of relative peace. Despite President Rajapaksa's stated economic goals of higher economic growth described in Mahinda Chintana, the IMF estimates that Sri Lanka can maintain only 6 percent sustained growth utilizing its current resources. If the GSL wishes to obtain a higher sustained growth rate, it will need to create an environment that is more friendly to foreign direct investment, as well as improve its health system and provide a better tertiary education system) one that ensures that its graduates are ready to work in today's business climate, and one that increases access for its qualified young people. (Note: Currently the state university system, which has a monopoly on Sri Lanka degree conferral, can only accommodate about 15 percent of those who qualify for tertiary education. End Note.)

15. (SBU) Commenting that the GSL is currently so focused on the conflict that its leadership cannot focus on economic development, Valdivieso identified Treasury Secretary P.B. Jayasundera and the Ministry of Planning and Implementation as the "visionaries" who could help move the country toward a more stable economic environment. He added that Central Bank Governor Nivard Cabraal, while performing well, is more of an "implementer" than a visionary, and must focus right now on the current needs of the GSL while trying to keep the economy afloat.

CORRUPTION CHALLENGES

16. (SBU) The Ambassador asked about Valdivieso's views on the prevalence of corruption in the GSL. Valdivieso responded that corruption is endemic, although some steps have been taken to reduce the leakage. For the last 10 years, the IMF has advised the GSL to simplify its revenue collection systems, to no avail. Instead of simplifying, the GSL has complicated its revenue collection mechanisms. While simplification is needed, Valdivieso conceded that it is quite difficult in any country to break up the "kingdoms" that exist in revenue collection. He identified a universal VAT as potential solution for revenue generation. However, since the provincial governments rely on sales tax to support their functions, he said the addition of a universal VAT would be extremely problematic politically.

17. (SBU) The GSL's procurement and other disbursement systems are also rife with corruption. Funds are frequently allocated and disbursed for projects that, if ever begun, typically are not completed. The Ambassador cited an example of how one GSL official (who received an award on December 9 for battling corruption) who decided to verify whether funds allocated for the building of culverts and other water channels were being used for their stated purpose. The official investigated and discovered that some funding was being used to build luxurious homes rather than channels, and other projects funded to build large channels resulted in only small ditches. That official received many complaints from Members of Parliament, but received backing from the

President,s office.

¶8. (SBU) According to Valdivieso, Treasury Secretary P.B. Jayasundera has been pushing the GSL toward greater accountability and more effective measurement of outcomes by moving the implementation of projects into a "sectoral" approach. The IMF has been encouraging this methodology, as well as the formation of an &expanded budget8 that would include NGO projects. Using this approach would enable the GSL to project its future financial obligations to maintain NGO-funded projects, such as schools, after initial NGO funding ceases. (Comment: An article in early December in the government newspaper announced that P.B. Jayasundera will resign from office. Despite his later statement that he does not plan to resign, the article suggests pressure by influential GSL officials to remove him from office. End Comment.)

IMF CLOSING ITS SRI LANKA OFFICE

¶9. (SBU) Valdivieso informed the Ambassador that the IMF will close its resident office in Sri Lanka. He cited a strategic restructuring of the IMF, which will locate resident offices in countries that have already accepted an IMF program, or are near entry into a program, and other countries of systemic importance or with major financial markets. He said that the GSL has already been officially informed of this move, and that a press release would be made public on December 18. He said that Sri Lanka is not even interested in entering into a program with the IMF. Factors contributing to this lack of interest include the numerous donors currently working with Sri Lanka (citing India, China, Iran, and the "traditional donors") that provide aid without the IMF,s conditions, requirements that the current GSL,s has no desire to fulfill.

¶10. (SBU) The GSL has encouraged the IMF to delay its withdrawal from Sri Lanka. But the closure continues to be scheduled for February 1. Valdivieso noted that the IMF,s five-member office in Washington will continue working with Sri Lanka, perhaps making more frequent visits.

¶11. (SBU) COMMENT: Valdivieso has served as IMF Resident Representative for almost two years in Sri Lanka. Working behind-the-scenes in providing advice to the GSL, he strategically reversed the style of his predecessor who was more visible and more outspoken as to how Sri Lanka could improve economically. While the current GSL does not heed criticism by locals or foreign officials who cast the GSL,s economic policy in a negative light, it also tends to ignore quiet and astute counsel, such as Valdivieso,s. His assessment of the GSL,s lack of economic discipline confirms Embassy,s view that the GSL is focusing on the conflict to the virtual exclusion of all else, and is dependent on temporary foreign assistance to sustain its economic viability.
BLAKE